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Collapsible Corporations under the Tax Reform Act of 1986

Boris I. Bittker
Yale University

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COLLAPSIBLE CORPORATIONS UNDER THE TAX REFORM ACT OF 1986

BORIS I. BITTKER*

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I. INTRODUCTION

In 1982, the American Law Institute described the collapsible corporation rules, set out in § 341, as "characterized by a pathological degree of complexity, vagueness and uncertainty."¹ Four years later, it became possible to augment this description by saying that § 341 became triply anomalous with the enactment of the Tax Reform Act of 1986. First, as a tax avoidance device, the collapsible corporation rested on a tax rule that was repealed in 1986.² Second, § 341 was nevertheless preserved virtually intact by the 1986 Act; indeed, its reach was slightly expanded.³ Third, the punitive remedy employed by § 341 to discourage the use of collapsible corporations became, at most, a slap on the wrist.⁴ Thus, the

* Sterling Professor of Law Emeritus, Yale University. This article is taken from the manuscript of the forthcoming fifth edition of BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, to be published by Warren, Gorham & Lamont, Inc. The author thanks his co-author, James S. Eustice, and Frederic A. Nicholson for editorial assistance.

¹ American Law Institute, *Federal Income Tax Project: Subchapter C* (1982), 111.

² The non-recognition of gain on corporate distributions of appreciated property under the pre-1987 versions of §§ 311 and 335 (codifying the so-called *General Utilities* doctrine, named after *General Utilities and Operating Co. v. United States*, 296 U.S. 200 (1935)).

³ This is a case of "*ratione cessante, sed non cessat lex ipsa*." In its classical form this maxim lacks the "*sed non*," but the author has long felt that the maxim could be improved. The expansion in 1986 was the extension of an amendment to § 341(a), so that it reaches short-term as well as long-term capital gain.

⁴ The conversion of capital gains into ordinary income, which no longer deprives the taxpayer of the rate differential formerly enjoyed by long-term capital gains, though it may still be disadvantageous in other respects (primarily if the taxpayer has offsetting capital losses); see *infra* text accompanying note 15. Two ancillary disabilities imposed on collaps-

first and second anomalies are neutralized, rather than multiplied, by the third.

We turn now to this complex, vague, uncertain, and anomalous provision.

The collapsible corporation first attracted attention in the motion picture industry in the late 1940's. A producer and a group of leading actors would organize a corporation for the production of a single motion picture. They would invest small amounts of cash and agree to work for modest salaries, and the corporation would finance the production with borrowed funds. When the motion picture was completed, but before it was released for public exhibition, the corporation would be liquidated.

Under the *General Utilities* doctrine and the statutory predecessor of § 311(a)(2), the corporation did not recognize gain on the liquidating distribution.⁵ The stockholders would report the difference between the cost of their stock and the value of their proportionate shares in the completed film (established on the basis of previews) as long-term capital gain rather than as ordinary income, at a time when there was a large disparity in the rates applicable to these two categories of income.⁶ For example, if their investment in the stock was \$100,000 and the value of the film was \$1.1 million, the shareholders' profit would be \$1 million, on which the capital gain tax at that time would have been \$250,000. Under the statutory predecessor of § 334(a), the basis of the film in the hands of the shareholders would be \$1.1 million. If the net rentals received thereafter equaled that amount, they would have no further gain or loss, since the fair market value of the film could be amortized against the rentals.⁷ In effect, the exhibition profit, which would have been taxed as ordinary income to the corporation (or to the producers if they had

ible corporations, disqualifying them under §§ 333 and 337, relating to certain complete liquidations and to sales in conjunction with liquidations, were eliminated in 1986 when the underlying provisions were themselves repealed.

⁵ See *supra* note 2. This part of the foundation on which the collapsible corporation rested was eliminated in 1986 by the enactment of §§ 336(a)(gain recognized by distributing corporation on liquidating distributions of appreciation) and 311(b)(1)(same result for nonliquidating distributions).

Section 121 of the (unenacted) Subchapter C Revision Act of 1985 would have repealed § 341, in conjunction with its proposed repeal of the *General Utilities* doctrine; see STAFF OF SENATE COMM. ON FINANCE, 99TH CONG.: FINAL REPORT ON SUBCHAPTER C (Comm. Print No. 47 (1985)).

⁶ In 1950, when the statutory predecessor of § 341 was enacted, the maximum rates applicable to individual taxpayers on long-term capital gain and ordinary income were 25% and 70% respectively. Under the Tax Reform Act of 1986, post-1987 capital gains will be subject to the same rate as ordinary income.

⁷ If the proceeds exceeded, or fell short of, the estimated fair market value, the shareholders would have additional income or deductible loss. In *O'Brien v. Commissioner*, 25 T.C. 376 (1955)(acq.), it was held that income in excess of the film's basis was taxable as ordinary income.

operated in noncorporate form from the outset) was converted into capital gain. Moreover, instead of two taxes (a corporate on the exhibition income and an individual tax at the capital gain rate on a sale or liquidation of the corporation), there was only one.

The collapsible corporation was also used by builders and investors for the construction of homes in residential subdivisions. A corporation would be created to construct the houses; it would be liquidated before the houses were sold; and the corporation would not recognize any gain on the liquidating distribution of the houses. The stockholders would report as long-term capital gain the difference between the cost of their stock and the value of the completed houses. The houses, which thus acquired a "stepped-up" basis equal to their fair market value at the time of distribution, would then be sold, ordinarily with no further gain or loss to be accounted for. Here again, only one tax would be paid instead of two and it would be computed at the favorable, long-term capital gain rate.

Section 341, enacted in 1950, attacked the collapsible corporation by requiring the shareholder's gain on the liquidation of the corporation to be reported as ordinary income rather than long-term capital gain, and by applying the same remedy to sales and exchanges of the corporation's stock.⁸ This extension was a necessary buttress to the treatment of liquidations; without it, the shareholders of a collapsible corporation would have been able to sell their stock to outside investors, reporting their profit as long-term capital gain; and the purchasers of the stock could then liquidate the corporation without recognizing any gain, since the value of the liquidating distribution would ordinarily be substantially the same as the cost of their shares.⁹

Thus, although the term "collapsible corporation" originally implied the use of a temporary corporation that was to be dissolved as soon as its tax avoidance purpose had been accomplished, § 341 as enacted was (and continues to be) much broader. Because it is not limited to liquidations but applies as well to sales and exchanges of the stock of a collapsible corporation, § 341 may come into play even though the corporation is in fact kept alive for an indefinite period of time.¹⁰

⁸ For unsuccessful early attempts by the IRS to attack collapsible corporations with non-statutory remedies, see *Herbert v. Riddell*, 103 F. Supp. 369 (S.D. Cal. 1952); *O'Brien*, 25 T.C. 376; see also *Commissioner v. Gross*, 236 F.2d 612, 618 (2d Cir. 1956), upholding the Tax Court's refusal to impute a salary to corporate officers who preferred to take their profits on a business venture in the form of capital gain distributions on their stock; *Jacobs v. Commissioner*, 224 F.2d 412 (9th Cir. 1955). For further discussion of possible nonstatutory weapons, see *Bittker & Redlich, Corporate Liquidations and the Income Tax*, 5 *Tax. L. Rev.* 437, 439-48 (1950).

⁹ This assumes that the liquidation was not effected until the sale was "old and cold"; otherwise, the liquidating distribution might be imputed to the "selling" shareholders, who would then be treated as selling the assets (rather than their stock) to the purchasers.

¹⁰ See *Burge v. Commissioner*, 253 F.2d 765, 767 (4th Cir. 1958)(statutory predecessor

II. THE FRAMEWORK OF SECTION 341

Although the details of § 341 are quite intricate, its basic principle is simple: A shareholder who disposes of stock in a collapsible corporation in a transaction that would ordinarily produce capital gain must instead report the gain as ordinary income. As just explained, this rule applies not only to liquidating distributions, but also to sales and exchanges of the collapsible corporation's stock. Two less frequent transactions are also covered: partial liquidations under § 302(b)(4) and distributions subject to § 301(c)(3)(A), relating to distributions that are not covered by corporate earnings and profits and exceed the basis of the shareholder's stock.¹¹

Section 341(a) is applicable only if the shareholder's gain would otherwise be capital gain.¹² Section 341(a) is also inapplicable to losses. Finally, by its terms § 341(a) applies to gains that otherwise "would be considered" as capital gain, but it does not of its own force make gain taxable; thus, it has no effect on a tax-free exchange of stock in a collapsible corporation (e.g., under §§ 351, 354, 355, 361, or 1036).¹³

Aside from the operative rules of § 341(a), the statute consists of: (a) a definition of the term "collapsible corporation"; (b) a statutory presumption in aid of the definition; (c) three sets of limitations that moderate the rules of § 341(a) in certain circumstances; (d) an escape for transactions involving a limited class of property, particularly rental real estate; and (e) a consent procedure that negates the application of § 341 to a corporation's shareholders if it waives the benefit of certain non-recognition provisions on a disposition of specified types of

of § 341 "was drawn in broad general terms to reach the abuse which had arisen, whatever form it might take"; see also *Braunstein v. Commissioner*, 374 U.S. 65 (1963).

¹¹ Partial liquidations and § 301(c)(3)(A) distributions resemble complete liquidations and sales of the corporation's stock, in that they generate capital gain or loss at the shareholder level.

There is a curious omission from this pattern: a distribution in redemption of stock that is treated as long-term capital gain under § 302(a). The omission, however, may be neutralized by the fact that most redemptions by collapsible corporations will reflect a "corporate contraction" and hence will constitute a partial liquidation, which is covered by § 341(a)(2).

¹² Thus, if a corporate distribution of money or property is treated as dividend income to its shareholders under § 301, § 341 does not apply. Similarly, if the stock is not a capital asset because the shareholder holds it as "dealer property," ordinary gain would result on its sale without resort to § 341(a).

Before 1986, § 341(a) was also inapplicable to transactions producing short-term capital gains; but it was extended to encompass such transactions by § 1804(i)(1) of the Tax Reform Act of 1986.

¹³ See Rev. Rul. 73-378, 1973-2 C.B. 113 (stock received in tax-free acquisitive reorganization of a collapsible corporation not tainted in hands of former shareholders of acquired corporation).

property. These aspects of § 341 are examined in the remainder of this Article.¹⁴

Before we turn to a more detailed analysis, however, § 341 must be placed in proper context; to put the point more bluntly, it must be cut down to size. From 1950, when the statutory predecessor of § 341 was enacted, until 1986, when the Tax Reform Act of 1986 was enacted, the operative remedy of § 341(a)—taxing the shareholder's gain as ordinary income rather than as capital gain—was a bitter pill for taxpayers to swallow. For transactions after 1987, however, the 1986 legislation eliminates the historic rate differential between ordinary income and long-term capital gains;¹⁵ and this means that taxpayers will fear application of § 341 only in limited circumstances—primarily when they have a stockpile of capital losses that can be offset against only \$3,000 of ordinary income but can be applied without dollar limitation against capital gains.

Thus, unless the historic rate differential is restored,¹⁶ the Internal Revenue Service will often have nothing to gain by applying § 341. On the other hand, for the same reason—and also because the corporation must now recognize gain on most distributions of appreciated property¹⁷—the collapsible corporation is no longer an appealing tax avoidance device.

III. THE DEFINITION OF "COLLAPSIBLE CORPORATION"

The term "collapsible corporation" is defined in § 341(b)(1) to mean a corporation that is formed or availed of:

- (1) Principally for the "production" of property (or for certain other activities discussed below); and
- (2) With a view to (a) a sale, liquidation, or distribution before the corporation has realized two-thirds of the taxable income to be derived from the property,¹⁸ and (b) a realization by the shareholders of the gain attributable to the property.

¹⁴ Because of the greatly reduced importance of § 341, the analysis of some details have been condensed; for fuller discussions, see BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ch. 12 (4th ed. 1979); Nicholson, *Collapsible Corporations—General Coverage*, 29-4th BNA TAX MGT. (1981); Ginsburg, *Collapsible Corporations—Revisiting an Old Misfortune*, 33 TAX L. REV. 307 (1978).

¹⁵ See *supra* note 6.

¹⁶ See CONFERENCE COMMITTEE, 99TH CONG., CONFERENCE REPORT ON THE TAX REFORM ACT OF 1986 (Rpt. No. 841 at II-106 (1986)) ("current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase").

¹⁷ See *supra* note 5.

¹⁸ Before 1984, the statutory benchmark was "a substantial part" of the taxable income, rather than two-thirds; for pre-1984 law, see *infra* note 41.

If we take the extreme case of a corporation organized solely to produce one motion picture, which, by agreement among the shareholders at the time of its creation, is to be sold as soon as the film is completed and before the corporation has realized any taxable income from the film, the applicability of § 341(b) is indisputable.¹⁹ Moreover, the use of an existing corporation for this purpose will not escape § 341(b), since it is applicable whether the corporation is “formed” or “availed of” for the specified purpose. Finally, although the collapsible corporation provisions are aimed primarily at attempts to convert untaxed corporate ordinary income into shareholder-level capital gain, the Supreme Court has held that there is no implied exception in § 341 for profits that would have been taxed as capital gain if the corporate assets had been owned and sold by the shareholders as individuals.²⁰ Accordingly, the operation of § 341 may serve to convert what would otherwise be long-term capital gain into ordinary income solely because of the use of a corporation.²¹

The “collapsible corporation” definition (which should be examined with a lively appreciation of the fact that the term is not confined to such classic collapsible patterns as the use of temporary corporations in the motion picture or construction industries) contains these elements:

1. *Formed or availed of.* Because § 341 reaches corporations that are either “formed” or “availed of” for the proscribed purposes, it is not confined to a corporation that is specially created for the purpose or that is dissolved as soon as the purpose has been achieved.²² Temporary corporations may be especially vulnerable, but a long life does not insure immunity.

2. *Principally for the Manufacture, Construction, or Production of Property.* Early debate on this aspect of the definition in § 341(b) centered on whether the word “principally” modified the language “manufacture, construction or production,” or referred instead only to the collapsible “view” test; if the latter was the correct interpretation, the statute would

¹⁹ Before 1987, a shareholder view to *liquidating* the corporation before it realized two-thirds of the potential income would have been as fatal as an intention to *sell* the stock. But, a liquidating distribution of the property is now treated by § 336(a) like a corporation sale of the assets, viz., any appreciation must be recognized by the corporation. Thus, if the shareholders intend to liquidate the corporation before it has realized two-thirds of the potential income, the intention will be frustrated by § 336(a); and their view, being self-destructive, ought not to count under § 341(b)(1)(A). On the other hand, § 341(b)(1)(A) continues to encompass an intention to *sell* the stock before corporate realization of at least two-thirds of the income.

²⁰ See *Braunstein v. Commissioner*, 374 U.S. 65 (1963); see also *Bailey v. United States*, 360 F.2d 113 (9th Cir. 1966) (no implied exception in § 341 for shareholders whose intent had been to liquidate the corporation in tax-free liquidation); Rev. Rul. 56-160, 1956-1 C.B. 633.

²¹ This phenomenon was largely responsible for the enactment in 1958 of the amnesty granted by § 341(e), discussed below in text accompanying notes 59-64.

²² See *Treas. Reg. § 1.341-2(a)* (1986); *Burge v. Commissioner*, *supra* note 10; *Glickman v. Commissioner*, 356 F.2d 108 (2d Cir. 1958).

have been appreciably narrowed in scope. The regulations adopted the former construction from the outset; and the courts soon agreed.²³ The result of these cases is that the corporation need only be formed or availed of principally for the manufacture, etc., of property, a condition satisfied by ordinary business corporations; the forbidden "view" need not be the principal reason for formation or use of the corporation.

Similarly, the definition of "manufacture, construction or production" has received an expansive interpretation by the courts and the Internal Revenue Service. This definition has two elements: (a) whether the questioned activity itself constitutes "production"; and (b) the duration of the activity (a matter that is significant not only in applying the "view" requirement, but also in applying the three year rule of § 341(d)(3), summarized below). The earlier opinions and rulings on this question suggested that practically any corporate activity that is materially related to a property-creating transaction would satisfy the statutory test,²⁴ but it has been held that the term "construction" does not include: (a) minor alterations or corrections of an existing structure that did not change its character or increase its fair market value; (b) the drilling of dry holes and unsuccessful exploration activities; or (c) various preliminary activities by a real estate construction corporation.²⁵

If the corporation goes beyond distinctly preliminary activities or mere

²³ See Treas. Reg. § 1.341-2(a)(1)(1986); *Weil v. Commissioner*, 252 F.2d 805 (2d Cir. 1958); *Burge v. Commissioner*, 258 F.2d 765 (4th Cir. 1959); *Mintz v. Commissioner*, 284 F.2d 554 (2d Cir. 1960).

²⁴ See, e.g., *Abbott v. Commissioner*, 28 T.C. 795 (1957), *aff'd*, 258 F.2d 537 (3d Cir. 1958) (corporation owning unimproved land held to have engaged in construction by contracting to install streets, obtaining FHA mortgage commitment, and depositing funds in escrow to insure that improvements would be installed); *Sterner v. Commissioner*, 32 T.C. 1144 (1959) (hiring mortgage broker and architect, application for FHA mortgage insurance, and negotiation of sales contract held construction); Rev. Rul. 56-137, 1956-1 C.B. 178 (rezoning of land from residential to commercial use held construction); Rev. Rul. 69-378, 1969-2 C.B. 49 (approval of lessee's construction plans, etc., is "construction"; "termination" is date following completion of physical construction); *Manassas Airport Indus. Park, Inc. v. Commissioner*, 66 T.C. 566 (1976), *aff'd per curiam*, 557 F.2d 1113 (4th Cir. 1977) (preliminary activities were construction; postliquidation construction also counted); *but see* Rev. Rul. 77-306, 1977-2 C.B. 103 (lessee construction not attributed to lessor who did not participate other than through higher rent).

²⁵ See Rev. Rul. 72-422, 1972-2 C.B. 211; Rev. Rul. 64-125, 1964-1 C.B. (Part 1) 131; *Calvin A. Thomas*, 50 T.C.M. (P-H) (P) 81, 387 (T.C. 1981), and cases there cited (purchase of land and modification of zoning not construction); *see also* *Computer Sciences Corp.*, 63 T.C. 327 (1974) (production of secret process completed when process ready for commercial use and production of income on commercial basis).

For the Internal Revenue Services' conservative policy on advance rulings, *see* Rev. Proc. 85-22, 1985-1 C.B. 550, § 4.01-17 (ordinarily no ruling on § 341(b) status, but request "will be considered" if corporation has been in existence twenty years, not more than 10 percent of its stock has changed hands, and it has conducted substantially the same business for that period).

maintenance of existing assets, however, it may be engaged in "construction." It should not be forgotten that engaging in such activity "to any extent" suffices under § 341(b)(2)(A). Thus, a conservative but useful rule of thumb is that "construction" has ended when "the last nail has been driven, the last brush stroke applied, and the last bush planted."²⁶

It would seem that any type of property that a corporation is capable of producing will meet the requirements of the statutory definition. Although most transactions that run afoul of § 341 involve the construction or production of tangible property (buildings, motion pictures, etc.), the creation of such intangibles as goodwill, secret formulas, industrial know-how, and the like, even by a service business, seem to be within the reach of the section, and the few reported cases have so held.²⁷

3. *Purchase of "Section 341 Assets"*. Even if the corporation does not engage in the "manufacture, construction, or production of property," it may fall within § 341 by engaging in the "purchase" of "section 341 assets," provided this is done with a view to a sale, liquidation, or distribution before the corporation has realized two-thirds of the taxable income to be derived from such property. This portion of the definition is primarily aimed at the use of collapsible corporations to convert the profit on inventory property and stock in trade into capital gain:

The procedure used is to transfer [an appreciated] commodity to a new or dormant corporation, the stock of which is then sold to the prospective purchaser of the commodity who thereupon liquidates the corporation. In this manner the accretion in the value of the commodity, which in most of the actual cases has been whiskey, is converted into a gain realized on the sale of stock of a corporation, thus creating the possibility that it might be taxed as a long-term capital gain.²⁸

Under this part of the definition of "collapsible corporation," every

²⁶ B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 12-9 n.17 (3d ed. 1971).

²⁷ See *King v. United States*, 641 F.2d 253 (5th Cir. 1981), and cases there cited; *F.T.S. Associates, Inc.*, 58 T.C. 207 (1972)(acq.)(marketing rights to a secret process created or purchased by corporate taxpayer).

²⁸ S. REP. NO. 781, 82d Cong., 1st Sess. (1951), reprinted in 1951-2 C.B. 458, 481. For a possible nonstatutory attack on this practice, see *Jacobs v. Commissioner*, 224 F.2d 412 (9th Cir. 1955).

For an application of § 341(b)(3) to a one-shot purchase and sale of a single parcel of real estate, see *Estate of Van Heusden v. Commissioner*, 369 F.2d 119 (5th Cir. 1966); but see *Calvin A. Thomas*, 50 T.C.M. (P-H) ¶ 81, 387 (T.C. 1981)(property not held for sale; *Van Heusden* distinguished); see also *King v. United States*, *supra* note 26 (one-shot sale of option to acquire tract of land held sale of "section 341 asset"); *Combs v. United States*, 655 F.2d 90 (6th Cir. 1981)(co-op conversion resulted in § 341 treatment for sale of stock because shareholders intended to profit from increased value of individual apartments).

corporation holding appreciated inventory or stock in trade would be a potential target for § 341, and its fate would depend on whether the elusive “view” was present; but the regulations cut down the scope of § 341(b)(2) by conferring immunity on the corporation if its inventory property—more precisely, the property described in §§ 341(b)(3)(A) and 341(b)(3)(B)—is normal in amount and if the corporation has a substantial prior business history involving the use of such property.²⁹

The term “section 341 assets” embraces not only inventory and property held for sale to customers in the ordinary course of business, but also unrealized receivables and fees from the sale of “section 341 assets” and property described in section 1231.³⁰ The latter category of property may have been brought within the aegis of § 341 to prevent dealers in apartment houses or other rental property from converting ordinary income into capital gain through the use of a separate corporation for each parcel of property. The result of treating § 1231(b) property as “section 341 assets” is that the typical real estate holding corporation, formed to purchase an apartment house or other rental property, may be collapsible if the requisite view is present, even though the shareholders are investors rather than dealers and would have been entitled to report their profit on the building as capital gain under § 1231 in the absence of a corporation.³¹

The collapsible corporation provisions had thus come full circle: Designed to prevent the transmutation of ordinary income into capital gain, they could now convert capital gain into ordinary income. In recognition of this possibility, Congress enacted § 341(e) in 1958 to provide an escape from collapsibility in cases where, roughly speaking, the taxpayers would have enjoyed capital gains had they not used the corporate form.³²

4. *With a “view” to “collapse”.* Since many, if not most, ordinary business corporations are formed or availed of principally for the production or purchase of property (especially since these terms are broadly

²⁹ Treas. Reg. § 1.341-5(c)(1)(1986); *see also* Rev. Rul. 56-244, 1956-1 C.B. 176 (inventory, although appreciated in value, was normal in amount for volume of sales and not in excess of average inventory over preceding several years; corporation held not collapsible).

³⁰ The term “section 341 assets” does not include § 1231 property used in connection with the manufacture, etc. of inventory property or of property held for sale to customers in the ordinary course of business; *see* § 341(b)(3)(D). On the troublesome question of “dual purpose” property, held for either development or sale, *see* *Malat v. Riddell*, 383 U.S. 569 (1966) (“primarily” as used in § 1221(1) means “of first importance”).

Regardless of the type of property involved, the term “section 341 assets” is limited to property held for less than three years, but (1) the tacking rules of § 1223 apply in determining the holding period, and (2) the period does not begin until manufacture, etc. is completed; *see* § 341(b)(3)(last sentence).

³¹ *See* *Braunstein v. Commissioner*, 374 U.S. 68 (1963)(no implied exception for transactions that would have generated capital gains if effected by shareholders as individuals).

³² For § 341(e), *see infra* text accompanying notes 59-64.

defined by § 341), the major issue in a § 341(b) case is usually the existence of the requisite view on the part of the shareholders to effect a sale, liquidation, or distribution before the corporation has realized two-thirds of the income to be derived from the property. The classic collapsible corporation was one whose shareholders planned at the very outset to liquidate before any corporate income was realized. The regulations, however, provide that § 341(b) is satisfied if a sale, liquidation, or distribution before the corporation has realized a substantial part of the gain from the property "was contemplated, unconditionally, conditionally, or as a recognized possibility."³³

This statement seems to suggest that the requisite view exists whenever the controlling shareholders can reasonably foresee that, if the price is "right," they may decide to sell their stock or liquidate the corporation before it realizes two-thirds of the income from its collapsible property. If so, the "recognized possibility" test is almost all embracing. The courts may, however, be unwilling to go this far, unless the shareholders are experienced professionals in the business at hand.³⁴

The regulations go on to state that the persons whose "view" is crucial are those who are in a position to determine the policies of the corporation, whether by reason of majority stock ownership or "otherwise." This approach may be hard on innocent minority shareholders, but without such a rule, § 341 could be too easily avoided by keeping one such shareholder in the dark. Finally, the regulations provide that the collapsible view must exist at some time during construction, production, or purchase of the collapsible property. Some courts have felt that the regulations are overly generous to the taxpayer in this respect, asserting that the view need only be held when the corporation is "availed of" for the collapsible purpose, even if production of the property has been completed by then; other decisions, however, have questioned or rejected this interpretation.³⁵ In any event, determination of the time when the

³³ Treas Reg. § 1.341-2(a)(2)(1986). For this outdated use of the term "substantial part" of the taxable income, rather than two-thirds, see *infra* note 41.

³⁴ For a willingness to infer the tainted view in cases involving real estate operators, see *August v. Commissioner*, 267 F.2d 829 (3d Cir. 1959); *Rechner v. Commissioner*, 30 T.C. 186 (1958); *Edward S. Zorn*, 45 T.C.M. (P-H) ¶ 76,241 (T.C. 1976) (distribution of excess mortgage proceeds taxable as ordinary gain because controlling shareholders formed view to distribute during construction and distribution was a "recognized possibility" before completion of construction); *Nordberg*, "Collapsible" Corporations and the "View", 40 TAXAS 372 (1962).

³⁵ See Treas. Reg. § 1.341-2(a)(3)(1986). For decisions holding or implying that the regulation is too generous, see *Glickman v. Commissioner*, 356 F.2d 108 (2d Cir. 1958) (dictum); *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960); *Burge v. Commissioner*, 253 F.2d 765 (4th Cir. 1958); for a view more in accord with the regulations, see *Jacobson v. Commissioner*, 281 F.2d 703 (3d Cir. 1960); *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959); *Tibbals v. United States*, 362 F.2d 266 (Ct. Cl. 1966) (sale not foreseeable prior to completion of construction; court refers to regulations' approach as "settled law"). See also

view arose will of necessity be difficult, involving as it does a highly subjective issue of intent, and the chronological breadth of the term "production" makes it difficult to establish that a tainted view, if it existed, did not arise until after production was completed.

It must be concluded, therefore, that the regulations bring within § 341 any corporation that is formed or availed of for the production or purchase of property if the persons in control recognize (before production is completed) the possibility of selling or liquidating the corporation at a profit before it has realized two-thirds of the income from its property. Moreover, the natural tendency of courts and administrators to assume that what actually did happen was intended is evident in this area, so that self-serving disclaimers of a tainted intent are likely to be less persuasive than the actual results. This emphasis on objective considerations is evident in Regs. § 1.341-5(b),³⁶ which states that a corporation "ordinarily" will be considered collapsible if (a) gain attributable to property produced or purchased by the corporation is realized by the shareholder on a sale of his stock or nondividend distribution; (b) the production or purchase of the property was a substantial corporate activity; and (c) the corporation has not realized the requisite portion of the taxable income to be derived from such property.³⁷

The regulations, however, mention one avenue of escape: proof that the decision to sell, liquidate, or distribute was "attributable solely to circumstances which arose after the manufacture, construction, production or purchase (other than circumstances which reasonably could be anticipated at the time of such [activity])."³⁸ Among the post-production circumstances that have been held to qualify are (a) illness of an active shareholder; (b) unexpected changes in the law; (c) dissents among the shareholders, especially if a minority interest is brought out; (d) unexpected changes in the value of the property; and (e) a shareholder's sudden need for funds to enter or expand another business.³⁹ This

Louis Kellner, 40 T.C.M. (P-H) (P) 71, 293 (T.C. 1971)(view to liquidate arose after construction due to unforeseeable change of conditions); F.T.S. Associates, Inc., 58 T.C. 207 (1972)(view to liquidate arose after alleged collapsible activity); Computer Sciences Corp., 63 T.C. 327 (1974)(same).

³⁶ Treas. Reg. § 1.341-5(b)(1986).

³⁷ For the Internal Revenue Service's practice with respect to requests for advance rulings, see *supra* note 25.

³⁸ Treas. Reg. § 1.341-2(a)(3)(1986).

³⁹ See Treas. Reg. § 1.341-2(a)(3)(1986); *Riley v. Commissioner*, 35 T.C. 848 (1961) (*acq.*) (illness); *Temkin v. Commissioner*, 35 T.C. 906 (1961) (*acq.*) (same); Treas. Reg. § 1.341-5(d), example 3 (same); Rev. Rul. 57-575, 1957-2 C.B. 236 (sale of property to United States under statute whose enactment was not anticipated); *Commissioner v. Lowery*, 335 F.2d 680 (3d Cir. 1964)(buy-out of minority shareholder who could not make additional investment); *Jacobson v. Commissioner*, *supra* note 35 (damage to property); *Southwest Properties, Inc., v. Commissioner*, 38 T.C. 97 (1962)(*acq.*)(change in property's value); *Cohen v. Commissioner*, 39 T.C. 886 (1963)(Nonacq.)(same); but see *Braunstein v. Commis-*

exception is less useful than might appear, however, because of the difficulty of proving that the cause of the sale could not have been initially anticipated, as well as because the production process may extend beyond "completion" in a layman's sense.⁴⁰

5. *Corporate Realization of Two-Thirds of Taxable Income From the Property.* A corporation can escape the taint of collapsibility under § 341(b)(1)(A) if, before the sale, exchange or distribution, it realizes two-thirds of the taxable income to be derived from its collapsible property.⁴¹

In theory, the amount *actually* realized is irrelevant, and the amount that the shareholders *intended* the corporation to realize is controlling. But this would make the corporation collapsible even if all the income had in fact been realized by it, provided the shareholder had earlier entertained the "view" that the income should not be realized by the corporation. The regulations, perhaps treating the events as they occur as the best evidence of what was intended, clearly imply that actual—rather than intended—realization is controlling.⁴²

If the collapsible property consists of fungible units in an integrated project (e.g., separate installments of a television or motion picture series, or individual units in a housing project), the amount realized is deter-

sioner, 374 U.S. 68 (1963)(change in value not controlling); Jack D. Saltzman, 32 T.C.M. (P-H) ¶ 63,080 (T.C. 1963)(need for funds); Stanley Stahl, 35 T.C.M. (P-H) ¶ 63,080 (T.C. 1963)(economic and business factors beyond taxpayer's control); George E. Freitas, 35 T.C.M. (P-H) ¶ 66,105 (T.C. 1966)(plan to sell arose after completion of construction); Computer Sciences Corp., 63 T.C. 327 (same); Crowe v. Commissioner, 62 T.C. 121 (1974)(*acq.*)(no view where sale of stock did not occur with "freedom of choice" contemplated by § 341(b), but was instead compelled by disagreement between equal shareholders).

⁴⁰ See *King v. United States*, *supra* note 26 (minimal acts sufficient); *Rechner v. Commissioner*, 30 T.C. 186 (1958); *Sproul Realty Co. v. Commissioner*, 38 T.C. 844 (1962)(*acq.*).

⁴¹ Before 1984, § 341(b)(1)(A)'s escape hatch referred to realization of "a substantial part" of the taxable income to be derived from the property, rather than two-thirds. In addition to the intrinsic vagueness of the word "substantial," there was a grammatical ambiguity in § 341(b)(1)(A); it was not clear whether the corporation was collapsible if it was sold or liquidated when a substantial part of the taxable income *remained to be realized*, or only if the sale or liquidation occurred before a substantial part *had been realized*. The latter interpretation was obviously more lenient; it would exempt the corporation if the shareholders planned to have it realize (for example) a third of the taxable income; on the other hand, the former interpretation would clearly not be satisfied on these facts, since two-thirds of the income would remain to be realized. For competing views on this issue, compare *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961)(realization of about one-third sufficient), with *Abbott v. Commissioner*, 28 T.C. 795 (1957)(corporation collapsible if substantial part remains to be realized); see also Rev. Rul. 72-48, 1972-1 C.B. 102 (acquiescing in *Kelley*, but stating that IRS was not precluded from applying unspecified other provisions of the Code to tax gain as ordinary income—presumably clear reflection of income, assignment of income, step transaction, and similar doctrines).

⁴² See Treas. Reg. §§ 1.341-2(a)(4)(1986), 1.341-5(c)(2); but see *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959).

mined by treating the aggregate of these properties as a single unit. Thus, if a corporation is engaged in constructing a housing project, the entire project would constitute a "single property" for realization purposes.⁴³ On the other hand, if the corporation constructs two unrelated office buildings, the sale of one will not protect it from collapsible treatment if the stock is sold before two-thirds of the income from the second is realized.

Apparently the "taxable income to be derived from the property" means the taxable income that would be realized if the property were sold at the time the shareholder's gain arises.⁴⁴ This test seems appropriate in the case of property held for sale (e.g., inventory or residential home units). But if rental property is involved, some courts require an estimate of the projected net rental income to be realized over the economic life of the property, a measure which is considerably more difficult to apply.⁴⁵ In addition, the fact that the property has produced no net income or is losing money has not precluded a finding of collapsibility where the prohibited view was present.⁴⁶

6. *Realization by Shareholders of Gain Attributable to the Property.* If the other elements of the collapsible definition are satisfied, the final element—realization by the shareholders of gain attributable to the collapsible property—will be satisfied almost automatically, since the appreciation will be reflected in the amount they receive for their stock.⁴⁷

7. *Scope of Term "Manufacture, Construct, Produce or Purchase".* To safeguard the statutory purpose, § 341(b)(2) provides that a corporation "shall be deemed to have manufactured, constructed, produced, or purchased property" if any of the following conditions are satisfied:

⁴³ See Treas. Reg. §§ 1.341-2(a)(4)(1986), and 1.341-5(d), examples 2 and 3. *But compare* § 341(d)(2), Treas. Reg. § 1.341-4(c)(3)(1986), and *infra* ¶ 12.06 (regarding computation under 70%-30% rule).

⁴⁴ See *Levenson v. United States*, 157 F. Supp. 244 (N.D. Ala. 1957); *Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961).

⁴⁵ See *Sidney v. Commissioner*, 273 F.2d 928; *Mintz v. Commissioner*, 284 F.2d 554 (2d Cir. 1960); *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959). The *Mintz* and *Sidney* cases also held that premiums received from a lender, with which an FHA mortgage was placed, were not part of the net income "to be derived from such property." See also *Manassas Airport Indus. Park, Inc.*, 66 T.C. 566 (1976) (determination of estimated net income from the property; revenues unrelated to collapsible activity excluded; also, losses reduce numerator. In *Estate of Van Heusden v. Commissioner*, 369 F.2d 719 (5th Cir. 1966), the court stated that substantial realization means realization of income from the ownership of property, not from its sale, a doubtful theory).

⁴⁶ See *Spangler v. Commissioner*, 278 F.2d 665 (4th Cir. 1959), *cert. denied*, 364 U.S. 825 (1960); *Short v. Commissioner*, 302 F.2d 120 (4th Cir. 1962).

⁴⁷ See, e.g., *Payne v. Commissioner*, 268 F.2d 617 (5th Cir. 1959) (shareholder's view to collapse and realization of gain attributable to collapsible property go hand in hand). For problems in determining whether the shareholder's gain is attributable to the collapsible property, see *infra* discussion of 70-30 exception of § 341(d)(2).

- (a) If the corporation engages in manufacture, construction, or production of property "to any extent." By virtue of this provision, the corporation need not have either originated or completed the process of manufacture, construction, or production; any interim contribution to the process is sufficient.
- (b) If the corporation holds property having a basis determined by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased it. This provision reaches such devices as the transfer of collapsible property by the manufacturer to an "innocent" corporation by a tax free exchange under § 351, or the use of a second corporation into which a collapsible corporation is merged.
- (c) If the corporation holds property having a basis determined by reference to the cost of other property manufactured, constructed, produced, or purchased by it. This provision prevents an escape from § 341 by a plan under which the corporation would manufacture property and transfer it for other property in a tax-free exchange (e.g., under § 1031), following which the shareholders would liquidate the corporation or sell their stock before the corporation had realized income from the newly acquired property.

A further buttress to § 341 is the inclusion of holding companies in the term "collapsible corporation." If a corporation is employed to hold the stock of a manufacturer of collapsible property, the parent corporation will be a "collapsible corporation" by virtue of § 341(b)(1) if it is formed or availed of with a view to a sale, liquidation, or distribution before the manufacturing subsidiary has realized at least two-thirds of the taxable income from the property.⁴⁸

IV. THE REBUTTABLE PRESUMPTION OF COLLAPSIBILITY

Section 341(c) establishes a rebuttable presumption of collapsibility if the fair market value of the corporation's "section 341 assets" is (a) 50 percent or more of the fair market value of its total assets, and (b) 120 percent or more of the adjusted basis of such "section 341 assets."⁴⁹ The

⁴⁸ See *Computer Sciences Corp.*, 63 T.C. 327 (1974) for a near-miss under this provision (parent had view to sell stock of subsidiary created to hold developed computer programs, but view arose after completion of development; thus subsidiary was not collapsible); see also Rev. Rul. 56-50, 1956-1 C.B. 1974 (holding company purged of collapsible taint when it sold subsidiary's stock and was taxed under § 341 on resulting gain). See generally Del Cotto, *The Holding Company as a Collapsible Corporation Under Section 341 of the Internal Revenue Code*, 15 BUFFALO L. REV. 524 (1966).

⁴⁹ Section 341(c) also provides that absence of these triggering conditions does not give rise to a presumption of non-collapsibility. For the scope of the term "section 341 assets," see § 341(b)(3), discussed text accompanying *supra* notes 28-29.

theory of this presumption is that if the "section 341 assets" are substantial in amount and have risen in value to a level significantly above their basis, it is reasonable to place the burden of disproving collapsibility on the taxpayer.

In order to prevent manipulation, § 341(c)(2) provides that cash, stock, and certain securities are to be disregarded in determining the corporation's "total assets"; otherwise, the shareholders of a corporation with substantially appreciated "section 341 assets" might attempt to avoid the statutory presumption by contributing liquid assets to the corporation's capital to dilute the "section 341 assets" to less than 50 percent of the total assets. Perhaps the business purpose doctrine could be used by the Commissioner as an alternative weapon against an attempt to drown the corporation's "section 341 assets" in a sea of other assets by contributions to capital having no nontax purpose.

In applying the presumption of § 341(c), the appreciation in "section 341 assets" is measured against their basis, not against the shareholders' investment. Thus, if the shareholders invest \$15,000 in a corporation, and it constructs "section 341 assets" at a cost of \$100,000 (represented by \$15,000 of equity investment and \$85,000 of borrowed funds), the presumption of § 341(c) will not be applicable if the assets increase in value to only \$115,000 (this being less than 120 percent of their basis), even though the appreciation (\$15,000) represents a profit of 100 percent on the shareholders' investment. If the assets increased in value to \$120,000, however, § 341(c) would become applicable; and this would be true even if the shareholders had financed the entire cost of construction (\$100,000) with their own funds and had enjoyed a gain of only 20 percent on their investment.

V. THE ESCAPE HATCHES OF SECTION 341(D)

Even though a corporation is "collapsible" under the foregoing principles, § 341(d) makes the punitive rules of § 341 inapplicable if any one of the following three conditions—applied shareholder-by-shareholder⁵⁰—is satisfied:

1. *Not more than 5 percent of stock.* A shareholder is not subject to § 341 unless he owns (a) more than 5 percent in value of the outstanding stock, or (b) stock that is attributed to another shareholder who owns more than 5 percent of the stock. The ownership of stock is determined under a set of constructive ownership rules,⁵¹ and the specified amount of

⁵⁰ Section 341(d) provides relief for the qualifying shareholder only; see *Leisure Time Enterprises, Inc. v. Commissioner*, 56 T.C. 1180 (1971) (collapsible corporation not entitled to use the pre-1986 version of § 337 (subsequently repealed) even though shareholders were protected from § 341(a) by § 341(d)(3)); Rev. Rul. 63-125, 1964-2 C.B. 146.

⁵¹ The constructive ownership rules applicable to personal holding companies, § 544, are

stock is fatal if owned when the manufacture, construction, or production of property is begun, when "section 341 assets" are purchased, or at any time thereafter.

2. *Not more than 70 percent of gain attributable to collapsible property.* Section 341(d)(2) insulates a shareholder's gain on a sale, liquidation or distribution from collapsible treatment unless more than 70 percent of the gain is attributable to the collapsible property. Thus, if 30 percent or more of the gain can be traced to noncollapsible property, the entire gain will qualify for capital treatment even though the corporation is collapsible under the general definition in § 341(b).

The 70 percent rule of § 341(d)(2) is of little relevance in the classic collapsible corporation situation, where the corporation purchases or constructs a single property. If that property is not a tainted asset—e.g., because over two-thirds of the income from it has been realized—then the corporation is not collapsible under the general definition and there is no need to look to § 341(d)(2) for relief. If, on the other hand, the property is a collapsible asset because of insufficient realization, then of necessity more than 70 percent of the gain—indeed all of the gain—is attributable to that property and § 341(d)(2) offers no relief.

But if a corporation holds two or more properties, it may be collapsible under the § 341(b) definition because of insufficient realization on any one property, notwithstanding full realization on the others.⁵² Thus, in the context of § 341(b), a finding that there is more than one property may hurt but can never help the taxpayer. Under the 70 percent rule, however, just the opposite is the case. For a finding that there are two separate properties permits the shareholder to avoid § 341 if 30 percent or more of his gain is attributable to the property on which there has been adequate realization, even though the greater part of the gain may be attributable to other properties which are collapsible. For example, assume that (1) Corporation X (wholly owned by A) owns Property Y and Property Z, which have appreciated by \$100,000 and \$200,000 respectively; (2) of the \$100,000 appreciation on Y, \$67,000 has been realized by the corporation, resulting in a tax of \$14,000, and \$33,000 is unrealized; (3) none of the Z appreciation has been realized; and (4) A sells his X stock at a gain of \$286,000 (realized gain on Y of \$67,000, unrealized appreciation on Y of \$33,000, unrealized appreciation on Z of \$200,000, less corporate tax paid of \$14,000). Of A's gain, 30.07 percent (\$86,000/\$286,000) is attributable to a noncollapsible asset (Y). Thus, if the properties are treated separately in apply the 70 percent rule, the realization of approximately 23 percent of the pretax income (\$67,000/

adopted for this purpose, except that the definition of "family" is expanded to include brothers, sisters, and their spouses.

⁵² Treas. Reg. § 1.341-2(a)(4)(1986) and § 1.341-5(d)(1986), Example 2.

\$300,000) to be derived from the properties would protect the shareholder against § 341.⁵³

In computing the gain attributable to the collapsible property, the regulations adopt a "but for" approach, i.e., it is the excess of the gain recognized by the shareholder over the gain he would have recognized if the collapsible property had not been constructed or purchased.⁵⁴ This determination takes into account not only the appreciation in value of the collapsible property, but also any accumulation of income produced by the property.⁵⁵ Further, consistent with the "but for" approach, gain may be attributable to the collapsible property even though it results from an increase in the value of property other than the property constructed or produced, if there is a casual relationship between the activity and the appreciation.⁵⁶

3. *Gain realized after expiration of three years.*

Section 341(a) treatment may also be avoided by a shareholder if gain on stock of a collapsible corporation is realized more than three years after the corporation completes production or purchase of the collapsible property.⁵⁷ (The shareholder's holding period for the *stock* is irrelevant; § 341(d)(3) is concerned only with the corporation's holding period for the property.) Although the statute is not crystal clear on this point, it is evidently not necessary for all of the corporation's collapsible property to be held for three years to bring § 341(d)(3) into play. Thus, if the corporation owns two collapsible projects, one of which has been held for

⁵³ Before the 1984 substitution of the two-thirds rule for the prior "substantial part" requirement (*see supra* note 38), the two-property rule could cut down the percentage of appreciate that had to be realized even more drastically. Recognizing that manipulation of the two-property principle was especially feasible in the case of fungible assets like inventory, in 1984 Congress enacted the final sentence of § 341(d) to authorize the Treasury to require all inventory assets to be aggregated in applying the 70% rule. *See Prop. Regs. § 1.341-4(d)(4)(1986)*.

⁵⁴ *Treas. Reg. § 1.341-4(c)(2)(1986)*.

⁵⁵ *Treas. Reg. § 1.341-4(c)(4)(1986)*.

⁵⁶ *Treas. Reg. § 1.341-4(c)(3)(1986)* (increase in value of property adjacent to collapsible property included, because attributable to construction on latter property). *See also* Rev. Rul. 65-184, 1965-2 C.B. 91 (gain attributable to project completed more than three years before realization of gain by stockholder is nonetheless included in gain attributable to collapsible property for purposes of 70% rule); *see also* Spangler v. Commissioner, 278 F.2d 665 (4th Cir.), *cert. denied*, 364 U.S. 825 (1960) (gains arising from construction contract refunds, rentals, and off-site improvements included in gain attributable to collapsible property); *Benedek v. Commissioner*, 429 F.2d 41 (2d Cir. 1970), *cert. denied*, 400 U.S. 992 (1971) (shareholder's gain on distribution of excess mortgage proceeds attributable to constructed buildings, not to leaseholds of land); *cf.* Mintz v. Commissioner, 284 F.2d 554 (2d Cir. 1960) (land and buildings constitute single unit in computing gain attributable to collapsible property); *Payne v. Commissioner*, 268 F.2d 617 (3d Cir. 1960) (same).

⁵⁷ *See* Rev. Rul. 57-491, 1957-2 C.B. 232 (three-year period includes holding period of certain predecessor owners of the property); Rev. Rul. 79-235, 1979-2 C.B. 135 (inclusion of holding period for property exchanged under § 1031).

more than three years, the portion of the shareholder's gain attributable to that project may qualify for relief under § 341(d)(3), even though the rest of the gain, reflecting the value of the more recent project, is taxable as ordinary income.

Because the terms "manufacture, construction and production" have such an expansive meaning,⁵⁸ the three-year rule of § 341(d)(3) is a treacherous exception: The waiting period commences only on "completion"—not partial or substantial completion—of the productive process. Moreover, production of "the" property must be completed; and if the corporation is engaged in multi-unit construction activities, it may be difficult to say whether there is only a single project, on which work is continuing, or several projects, one or more of which have been completed.

VI. THE AMNESTY OF SECTION 341(E)

Section 341(e) ameliorates the rigors of the collapsible corporation provisions on a shareholder-by-shareholder basis by exempting a shareholder's gain from § 341(a)(1) (thus allowing it to qualify as long-term capital gain) if the stock is sold or exchanged and specified conditions are satisfied.⁵⁹ These prerequisites to the application of § 341(e), which are unusually complex even by Internal Revenue Code standards, are best approached after their purpose is described.⁶⁰

Under § 341(b)(3)(D), which was enacted in 1954, a corporation formed or availed of to purchase rental property (e.g., an apartment house) may be a collapsible corporation even though the shareholders could, in the alternative, have acquired the property as individuals and reported their gain on a sale as long term capital gain unless they were dealers in such

⁵⁸ See *supra* text accompanying notes 23-27.

⁵⁹ See also § 341(e)(11) (failure to qualify under § 341(e) not relevant in determining whether corporation is collapsible). Before 1987, § 341(e) applied not only to sales and exchanges, but also to the shareholder's gain on certain liquidating distributions, but § 341(e)(2), the applicable provision, was repealed in 1986 because the distribution itself became a taxable event at the corporate level under § 336, as amended by the Tax Reform Act of 1986. Two other exemptions granted by § 341(e) relating to the status of the corporation itself under §§ 333 and 337 were also repealed by the 1986 Act, subject to certain transitional grandfather clauses. It was probably intended that the repealed provisions of § 341(e) will continue to apply to complete liquidations before January 1, 1989, of certain small corporations that meet the transitional rules in Section 633(d) of the Tax Reform Act of 1986. For the application of § 341(e) in situations not governed by the changes made by the 1986 Act, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 12-32 through 12-35 (4th ed. 1979).

⁶⁰ Because the Tax Reform Act of 1986 greatly reduced the importance of § 341 itself (see *supra* text accompanying 15-17), this description of § 341(e) is abbreviated. For more extensive analysis, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* and the other references cited *supra* note 14.

property.⁶¹ Recognizing § 341's potential for overkill in situations of this type, Congress enacted § 341(e) in 1958. Its underlying theory is that the collapsible corporation provisions should not be applicable if the net unrealized appreciation in the corporation's "subsection (e) assets" (roughly speaking, property held by the corporation that would produce ordinary income if sold by the corporation itself or by its principal shareholders) amounts to less than 15 percent of the corporation's net worth.

The term "subsection (e) assets" is employed throughout § 341(e) as the means of determining if there has been a significant appreciation in the value of the corporation's ordinary income assets. This term is defined by § 341(e)(5)(A) to include the following categories of property:

(1) *Property not used in the trade or business.* Any such property is a "subsection (e) asset" if the corporation's gain on a sale would be taxed as ordinary income—i.e., if the property is neither a capital asset nor § 1231(b) property. Moreover (and this is § 341(e)'s unique innovation), property held by the corporation is brought into this category if in the hands of any shareholder owning (directly or constructively) more than 20 percent in value of the corporation's stock it would not be a capital asset or § 1231(b) property. Thus, property held by the corporation constitutes a "subsection (e) asset" if it is stock in trade, inventory property, or property held for sale to customers in the ordinary course of trade or business in the hands of the corporation, or *if it would have this status were it held by any shareholder owning directly or constructively more than 20 percent, of the corporation's stock.*⁶²

2. *Property used in the trade or business—net unrealized depreciation.* If there is net unrealized depreciation on assets used in the trade or business, they constitute "subsection (e) assets."

3. *Property used in the trade or business—net unrealized appreciation.* If there is net unrealized appreciation on such assets, they constitute "subsection (e) assets" if they would be neither capital assets nor § 1231(b) assets in the hands of a more-than-20-percent shareholder. This provision is crucial to the purpose of § 341(e). If a corporation's sole property is an apartment house or other rental property that has appreciated in value, the property will constitute a "subsection (e) asset" only if a more-than-20-percent shareholder is a dealer in such property.

4. *Copyrights and similar property.* A copyright, literary composition, letter, memorandum, or similar property is a "subsection (e) asset" if it

⁶¹ In *Braunstein v. Commissioner*, 364 U.S. 65 (1963) the Supreme Court refused to provide a judicial escape for property that would have constituted a capital asset in the shareholder's hands, but this decision came after the enactment of § 341(e) and relied in part on the existence of this statutory escape.

⁶² See *King v. United States*, 641 F.2d 253 (5th Cir. 1981)(more than 20% shareholder was dealer in similar property, so corporation's assets were "section 341(e) assets").

was created in whole or in part by the personal efforts of an individual owning directly or constructively more than 5 percent of the corporation's stock or, in the case of letters and memoranda, if it was produced for such a 5 percent shareholder.

The definition of "subsection (e) assets" is employed by § 341(e)(1), which makes § 341(a)(1) inapplicable to the shareholder's gain on a sale or exchange of stock if the net unrealized appreciation in the corporation's "subsection (e) assets" does not exceed 15 percent of the corporation's net worth and if the shareholder does not own more than 5 percent of the corporation's stock. If the shareholder owns between 5 and 20 percent of the stock, a similar calculation is made, but it must take into account not only the corporation's "subsection (e) assets," but also any corporate assets that would produce ordinary income if held by the particular shareholder for whom the calculation is made. Finally, if the shareholder owns more than 20 percent of the stock, *his* calculation must also take into account any corporate assets that would have produced ordinary income (a) if he owned them, and (b) if he had held in his individual capacity the property of certain other corporations of which he owned more than 20 percent of the stock in the preceding three years. For all of these percentage computations, constructive as well as actual ownership is taken into account.

Thus, the corporate assets will be tainted by the dealer status of any shareholder owning more than 20 percent of the stock of the corporation—and this taint will affect all shareholders of the corporation, regardless of the size of their shareholdings. In addition, a shareholder owning more than 5 percent of the stock must take into account any other corporate assets that would be ordinary income assets if he held them in his personal capacity—but this taint will affect only him. Finally, as to a more-than-20 percent shareholder, any corporate assets will be tainted by the hypothetical dealer status he would have attained if he had engaged in certain transactions as an individual rather than in corporate form during the preceding three years.

These extraordinary statutory gyrations can be illustrated by assuming that Smith-Jones, Inc. is owned equally by Smith and Jones (who are unrelated); that its sole asset is an appreciated apartment house;⁶³ that neither Smith nor Jones is a dealer in such property, and that Jones has owned more than 20 percent of the stock of certain other real estate corporations during the preceding three years. In these circumstances, Smith-Jones, Inc. owns no "subsection (e) assets," either in its own right or by attribution from Smith or Jones. As to Smith, the net unrealized appreciation under § 341(e)(1) is zero. Thus, a sale or exchange of Smith's

⁶³ For a more complex, but less typical, illustration of the operation of § 341(e), see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, 12-30 and 12-31 (4th ed. 1979).

stock (except to the issuing corporation or to a related person) is exempt from the operation of § 341(a)(1).

As to Jones, it is necessary to determine whether more than 70 percent in value of the assets of any of his other corporations are similar or related in use or service to the property held by Smith-Jones, Inc. If so, Jones is to be treated as though any sale or exchange by him of stock in any such other corporation (while he owned more than 20 percent of its stock) had been a sale by him of his proportionate share of that corporation's assets.⁶⁴ The mere fact that the Jones corporations were or were not dealers in the property in question is not relevant; the purpose of imputing sales to Jones is to determine *his* status, based on both these hypothetical sales and any actual sales by him of similar properties held in his individual capacity. The number and frequency of sales are usually only two of the factors determining whether the taxpayer is a dealer, however, and it is not clear whether § 341(e)(1)(C) attributes to the shareholder not only his proportionate share of the corporation's assets, but also his share of any corporate activity (use of agents, advertising, etc.) which may have resulted in the sales.

If, taking into account these hypothetical sales or exchanges by Jones, he would have been a dealer in the type of property held by Smith-Jones, Inc., he can make use of § 341(e)(1) only if the net unrealized appreciation in the apartment building owned by Smith-Jones, Inc., does not exceed 15 percent of its net worth.

Finally, § 341(e)(1) cannot be invoked if the stock is sold to the issuing corporation, nor does it apply to a more-than-20-percent shareholder if the stock is sold to a "related person" as defined by § 341(e)(8).

VII. AVOIDANCE OF SECTION 341 BY A SECTION 341(F) CONSENT

Not content with the three original escape hatches of § 341(d) and the labyrinthine escape route of § 341(e), Congress provided further relief from § 341 in 1964 by enacting the consent procedure of § 341(f). This provision permits a shareholder to sell stock on the normal capital gain basis, free of any threat from § 341(a), if the corporation consents to recognize gain on its "subsection (f) assets" (primarily real estate and noncapital assets) when, as, and if it disposes of them in certain transactions that would otherwise qualify for nonrecognition of its gain. The common characteristic of these transactions is that, before the enactment of the Tax Reform Act of 1986, the corporation would not have recognized gain on its disposition of the property, but the basis of the

⁶⁴ Section 341(e)(1)(C)(ii) also takes into account for this purpose certain transactions under pre-1987 § 337. The Tax Reform Act of 1986 replaces old § 337 (subject to certain transitional grandfather clauses) with an identically-numbered but totally different provision.

property in the hands of the transferee was stepped up to fair market value.⁶⁵ The rationale of the consent is that the shareholder should be protected against the application of § 341(a) if the corporation *promises to recognize* its collapsible gain after he disposes of his stock, just as he has always been protected if the corporation *actually recognizes* the gain before he sells his stock.⁶⁶

The impact of a § 341(f) consent, however, was dramatically altered by the enactment of the Tax Reform Act of 1986, since the events to which the consent applies were deprived of their nonrecognition status.⁶⁷ Thus, except in a few transitional situations, a consent is now redundant, since it merely requires the consenting corporation to recognize gain on dispositions that are now taxable in any event by virtue of the 1986 changes.⁶⁸ While a pre-1987 consent entailed a loss of a corporation's opportunity to avoid the recognition of gain on certain liquidating and other distributions to its shareholders, a consent no longer requires the corporation to give up significant tax allowances, unless it qualifies for transitional relief or some future Congress revives the *General Utilities* doctrine. Consents, therefore, may become more common, even though § 341(a) itself is far less threatening than it was before 1987. As a tactical gambit, a consent now accomplishes less than it formerly did, because the disparity between long-term capital gains and ordinary income is far less significant than formerly, as noted earlier,⁶⁹ but its cost is now disproportionately lower.

The relief granted by § 341(f) applies only if the shareholder engages in a "true" sale of stock, not in a transaction that is assimilated to a sale for some purposes (e.g., a distribution in redemption of stock, a partial or complete liquidation, or a nonliquidating distribution).⁷⁰ To qualify for § 341(f)(1) treatment, the corporation and any subsidiary (or chain of subsidiaries) connected by stock ownership of five percent in value must

⁶⁵ Under § 341(e)(3), the consent does not apply to dispositions that entail no change in the basis of the property, such as tax-free reorganizations; see *infra* text accompanying notes 70-71.

For use of a consent, see *King v. United States*, 641 F.2d 253; for exhaustive analysis of the consent privilege, see Nicholson, *Collapsible Corporations - Section 341(f)*, 49-2d BNA TAX MGT. (1983).

⁶⁶ See *supra* text accompanying note 42.

⁶⁷ See §§ 311(b)(1) and 336(a); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (5th ed. 1987).

⁶⁸ A few unusual transactions, however, may trigger the recognition of gain under § 341(f)(2) but not under the statutory rules cited in note 64 (e.g., abandonment, retirement, and gifts); see *infra* note 72.

⁶⁹ See *supra* note 4.

⁷⁰ Treas. Reg. § 1.341-7(a)(2)(i) narrows the term "sale" still more, limiting it to sales that would produce long-term capital gain but for § 341. Query the result of this restriction on the expansion of § 341(a) in 1986 to encompass short-term capital gains; see *supra* note 12.

file a consent to the recognition of gain provisions of § 341(f)(2).⁷¹ A consent is not conditioned on a showing that the corporation is in fact collapsible; indeed, one of the advantages of § 341(f) is that it permits avoidance of such a determination. If the consent is filed, however, it cannot be repudiated at a later time on the ground that it was an empty formality because the shareholder's gain was not within the scope of § 341.

The consent becomes irrevocable as soon as any shareholder has effected a sale of his stock. Section 342(f)(2) then provides for recognition of gain at the corporate level on the ultimate disposition of all "subsection (f) assets," even in a transaction that would otherwise qualify for nonrecognition of gain⁷²—subject to an exception for tax-free exchanges under § 332 (liquidation of subsidiary), § 351 (transfer to controlled corporation), § 361 (corporate reorganizations), § 371(a) and § 374(a) (bankruptcy reorganizations), provided the basis of the assets carries over to the transferee and it files a similar consent to recognize gain when it disposes of them.⁷³

For six months after the filing of a consent, any shareholder may safely sell stock of the consenting corporation in one or a number of transactions. When the consent expires, a new one may be filed, which is similarly effective for a six-month period, whether the shareholders have made sales under the prior consent or not; and this process may be continued indefinitely. The use of the privilege with respect to *one* corporation, however, precludes the same shareholder, or any person related to him within the meaning of § 341(e)(8)(A), from using it with respect to any other corporation for a five-year period.⁷⁴ There is a "first-in—first-out" quality to this one-shot rule, in that a shareholder cannot disregard a consent applicable to his first sale of stock (either because he had no gain or because he is prepared to prove that the corporation was noncollapsible), in order to get the benefit of a consent filed by another corporation whose stock he sells at a later time.

"Subsection (f) assets" are defined in § 341(f)(4) as noncapital assets that the corporation owns, or has an option to acquire at the date of any qualified sale of stock by a shareholder. Without regard to whether they would otherwise constitute noncapital assets, however, land, any interest in real property (except a mortgage or other security interest), and

⁷¹ For the mechanics of the consent procedure, see Treas. Reg. § 1.341-7(b)(1986), 1.341-7(c)(1986), 1.341(d)(1986), 1.341-7(j)(1986). See also § 341(f)(8)(foreign corporation's consent not effective except as allowed by regulations).

⁷² See Treas. Reg. § 1.341-7(e)(7)(1986)(disposition includes abandonment, gift, sale-and-leaseback transaction, ect., but not borrowing on security of property).

⁷³ See generally Treas. Reg. §§ 1.341-7(e)(1986), 1.341-7(f)(1986); see also § 341(f)(8)(B) (exemption for tax-free transactions with carryover basis inapplicable if transferee is a foreign corporation, except as allowed by regulations); Treas. Ref. § 1.341-7(h)(1986).

⁷⁴ See Treas. Reg. § 1.341-7(g)(1986).

unrealized receivables or fees as defined by § 341(b)(4) constitute “subsection (f) assets.” This is also true of two other categories of property: (a) if any assets in the above categories are being manufactured at the time the stock is sold, the property resulting thereafter from the manufacturing process; and (b) in the case of land or real property, any improvements resulting from construction commencing within two years after the stock is sold. The character and amount of the corporation’s gain on disposing of its “subsection (f) assets”, however, depend on their status at the time of disposition, not on their status when the consent is filed or the stock is sold.